ARIZONA-AMERICAN WATER COMPANY

DOCKET NO. W-01303A-05-0405
and
DOCKET NO. W-01303A-05-0910

SURREBUTTAL TESTIMONY

OF

WILLIAM A. RIGSBY

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

MARCH 6, 2006

INTRODUCTION

Q. Please state your name, occupation, and business address.

A. My name is William A. Rigsby. I am a Public Utilities Analyst V employed by the Residential Utility Consumer Office ("RUCO") located at 1110 W. Washington, Suite 220, Phoenix, Arizona 85007.

Q. Please state the purpose of your surrebuttal testimony.

A. The purpose of my testimony is to respond to Arizona-American Water Company Inc.'s ("Arizona-American" or "Company") rebuttal testimony on RUCO's recommended rate of return on invested capital (which includes RUCO's recommended cost of debt and cost of common equity) for the Company's Paradise Valley Water District ("PV Water") located in Maricopa County.

Q. Have you filed any prior testimony in this case on behalf of RUCO?

A. Yes, on January 17, 2006, I filed direct testimony with the Arizona Corporation Commission ("ACC" or "Commission"). My direct testimony addressed the cost of capital issues that were raised in Arizona-American's application requesting a permanent rate increase ("Application") based on a test year ended December 10, 2004 ("Test Year").

Q. How is your surrebuttal testimony organized?

A. My surrebuttal testimony contains four parts: the introduction that I have just presented; a summary of Arizona-American's rebuttal testimony; a section on the cost of debt; and, a section on the cost of equity capital.

SUMMARY OF ARIZONA-AMERICAN'S REBUTTAL TESTIMONY

Q. Have you reviewed Arizona-American's rebuttal testimony?

A. Yes. I have reviewed the rebuttal testimony of Company witness A. Lawrence Kolbe, Ph.D. Dr. Kolbe's rebuttal testimony, filed on February 13, 2006, addresses the cost of common equity issue in this case.

Q. Please summarize the Company's rebuttal testimony that addresses the cost of capital issues in this case.

A. Dr. Kolbe's rebuttal testimony takes issue with the cost of equity capital recommendations made by ACC Staff witness Dennis Rogers and myself. Dr. Kolbe agrees with our decisions to make upward adjustments to our original cost of equity estimates in order to reflect the Company's leveraged (i.e. debt-heavy capital structure). However, Dr. Kolbe is critical of our final recommended costs of equity and argues that they are not high enough to compensate investors for the amount of financial risk that Arizona-American is exposed to. Dr. Kolbe continues to advocate the use of his after tax weighted average cost of capital ("ATWACC") methodology, which produces estimates ranging from 12.00 to 13.00

percent, to justify Arizona-American's request for a 12.00 percent return on common equity.

Q. Briefly summarize the positions of the parties to the case in regard to capital structure, cost of debt, cost of equity and weighted cost of capital.

A. Despite a difference of opinion between ACC Staff and the Company regarding Mr. Rogers' recommendation to require Arizona-American to achieve an equity ratio of 40 percent prior to the Company's next rate case filing, all of the parties to the case, who have filed testimony on cost of capital issues, appear to be in agreement on the Company-proposed capital structure of 63.0 percent debt and 37.0 percent equity. Likewise there appears to be a consensus on the Company-proposed 5.4 percent weighted cost of debt. The main point of contention appears to be a cost of common equity estimate that reflects the Company's debt-heavy capital structure. The costs of common equity being recommended are as follows:

Arizona-American	12.00%
ACC Staff	10.40%
RUCO	10.00%

The parties are much closer in terms of their recommended weighted costs of capital, which are as follows:

Arizona-American	7.80%
ACC Staff	7.20%
RUCO	7.10%

As can be seen above, there is only a 70 basis point difference between the Company-proposed 7.80 percent weighted cost of capital and RUCO's recommended weighted cost of capital of 7.10 percent.

Q. In your direct testimony, you described the differences between how you arrived at your final recommended 10.00 percent cost of common equity and how Company witness Dr. Michael J. Vilbert, arrived at his estimates. Please provide a similar comparison between your estimate and the estimate recommended by ACC Staff witness Dennis Rogers.

A. Mr. Rogers arrived at his original estimate of 9.80 percent by averaging the results of his DCF and CAPM models. He then made an upward adjustment of 60 basis points, to arrive at his final recommended cost of equity figure of 10.40 percent. The 60-basis point adjustment was based on the results that Mr. Rogers obtained from a technique developed by Robert Hamada, which relies on the use of a levered beta in the CAPM.

…

Q. What would your original unadjusted cost of equity estimate be if you were to average the results of your DCF and CAPM models as ACC Staff has?

A. Averaging the results of my water company sample DCF result of 9.50 percent, and my water company sample CAPM result (using an arithmetic mean) of 10.08 percent produces the same 9.80 percent original unadjusted result obtained by Mr. Rogers. My 50 basis point adjustment for Arizona-American's increased leverage, which was based on the return on common equity authorized in the Company's most recent rate case decision, is only ten basis points lower than the results produced by the Hamada technique employed by Mr. Rogers. My final estimate, after averaging the results of my DCF and arithmetic mean CAPM models as ACC Staff has, would be 10.30 percent as opposed to Mr. Rogers' recommended 10.40 percent. Using the aforementioned 10.30 percent cost of common equity in the Company-proposed capital structure produces the same 7.20 percent weighted cost of capital recommended by ACC Staff. Consequently, there is little difference between the result rendered under ACC Staff's methodology versus mine.

COST OF DEBT

Q. Has the Company accepted RUCO's recommended cost of debt?

A. I am not aware of any rebuttal testimony filed by the Company on the cost of debt recommendations made by either ACC Staff or RUCO. Both Mr. Rogers and I are recommending that the Commission adopt the

Company-proposed 5.4 percent cost of debt, which is the weighted cost of Arizona-American's various long-term debt instruments and PILR arrangements. At this juncture I believe it is safe to say that all of the parties to the case are in agreement on the aforementioned 5.4 percent figure and that the cost of debt is not an issue.

COST OF EQUITY CAPITAL

Q. Please summarize the rebuttal testimony of Dr. Kolbe.

A. As I noted in my introduction, Dr. Kolbe agrees with my decision to make an upward adjustment to my original DCF derived cost of equity capital of 9.50 percent, but believes that my final recommended cost of equity of 10.00 percent does not adequately reflect the level of financial risk that Arizona-American faces, and that I have failed to adequately quantify my upward adjustment of 50 basis points. Dr. Kolbe has also taken the position that the views that I expressed in my direct testimony regarding his ATWACC methodology for determining an appropriate cost of capital were unwarranted and has claimed I disparaged his reliance on the work of Profs. Franco Modigilani and Merton Miller. He further states that my dismissal of their work on capital structure is unwarranted given my own reliance on the work of scholars such as Myron Gordon and William Sharpe.

Q. Please address Dr. Kolbe's assertion that you failed to quantify the upward 50 basis point adjustment that you made to your original DCF result of 9.50 percent?

A. I have made no secret of how I arrived at my 50 basis point adjustment. As I stated earlier in my introduction, and also in my direct testimony, I used the 50-basis point adjustment that was authorized in the most recent Arizona-American rate case proceeding. Given the fact that ACC Staff has produced an adjustment that is only ten basis points higher leads me to conclude that my adjustment is in the ballpark for Arizona-American and that I have recommended a reasonable final estimate for the Company's cost of common equity. It is interesting to note here that the Commission recently adopted a 9.50 percent return on common equity for Southwest Gas Corporation (a local gas distribution company that has similar risk characteristics to water providers), which had slightly less common equity in its actual capital structure than Arizona-American. From the perspective of the Commission's decision on Southwest Gas Corporation, the 10.40 percent and 10.00 percent costs of common equity being recommended by Mr. Rogers and myself appear to be generous. They also appear to be much more reasonable than the 12.00 percent cost of common equity being requested by the Company, which is close to the historical 12.40 percent return on the stock market that I used in my CAPM model using an arithmetic mean.

Q. Were your direct testimony remarks intended to disparage Dr. Kolbe's reliance on the work of other noted scholars in the field of finance?

A. No they were not. If I offended Dr. Kolbe, I apologize. However, Dr. Kolbe even admits, on page 30 of his rebuttal testimony, that the same principles he is advocating in this case have only been adopted by one state utility commission out of fifty. As a practitioner in the field of finance, as opposed to being an academician, I tend to take a more practical approach in these cases. My remarks were mainly intended to put a sanity check on this process and to illustrate the fact that as a regulated utility, Arizona-American cannot be viewed in the same light as companies that operate in a purely competitive environment, a point on which Dr. Kolbe and I appear to be at odds.

Q. Can you give an example that supports your position that Arizona-American faces less risk, even with a leveraged capital structure, as a result of being a regulated utility as opposed to a business that operates in a competitive environment?

A. I believe I can. I happen to enjoy eating pizza, so just for the sake of argument I will use a pizza parlor as an example of a business that operates in a competitive environment.

Suppose you are the owner of a pizza parlor in a large metropolitan area such as Phoenix. You not only compete with a large number of small local pizza businesses, such as your own, but also with several large national pizza chains. Because of this, you not only have to make a good pizza but you also have to price your pizza competitively in order to attract and keep your customers. You are somewhat fortunate by virtue of the fact that all of the assets that you use to make and sell your pizzas have been paid for entirely, so you have 100 percent equity in your pizza business. Now let's say that one night, just before closing, your oven, which is a key asset in your business, breaks down. To your dismay the oven is beyond repair and has to be replaced. This could not have happened at a worse time since you do not have enough funds available in either your pizza business cash account or your own personal savings account to purchase a new oven. In order to stay in business, you have no choice but to borrow money and buy a new oven. The next morning you manage to obtain a 3-year loan for $15,000 from your bank by using your business assets as collateral. You are able to buy a new oven and get it installed before regular business hours. So you are back in business, but it is now costing you more to make the pizzas that you sell. This is because you now have depreciation expense on the new oven, which will be used to pay down the principal portion of the loan that financed it, and you now have interest expense as well. This means your bottom line is not as big as it was when you had no debt so your business is not as profitable. Nor is your business producing the same rate of return that it was before you had to take on the debt to buy the new oven. Does this mean you simply raise the price of your pizza to restore your original level of bottom line profit and your old rate of return? No. More than likely you can't because you will lose business because your pizza would no longer be competitively priced. Does this mean that you go before the Arizona Pizza Commission and seek an increase in your prices to be able to restore the level of profit that you have become accustomed to, or will make your business attractive to a potential buyer? No, because there is no Arizona Pizza Commission to go to. The pizza business is not a regulated business. You are in a competitive business and if another major asset fails you or your other operating expenses (such as the price of gasoline, needed to deliver your product, or natural gas, used to heat your oven) increase to the point that you are operating at a loss that exceeds your operating cash flows you may not have any other choice but to file for bankruptcy or liquidate your business. Compare this scenario with a regulated utility, like Arizona-American, that does have a regulatory commission to go to and seek increases in its rates when it is not making its required rate of return.

If you think my pizza parlor example is silly, then think about the airline industry for a moment. A good argument could be made that the airline industry has a lot in common with the utility industry. Like utilities, airlines are capital intensive. They must spend large sums of money to obtain their planes either through leasing or debt financing. This of course is a barrier to entry and limits the number of companies that can get into the airline business. The airline industry was regulated once but during the

Seventies the airline industry was deregulated and forced to operate in a competitive environment. As anyone who reads the business pages knows, since the advent of airline deregulation Chapter 11 bankruptcy protection has become routine for the major carriers that have managed to survive in a business that can no longer seek fare increases from a civil aeronautics board[1].

Q. Does the investment community at large recognize the fact that regulated utilities, such as Arizona-American, are indeed different from non-regulated entities in terms of how they recover their costs?

A. Yes, I believe more so than Dr. Kolbe probably would like to admit. For example, over the past year several articles on investing in the water infrastructure industry have appeared on the Internet, such as MSN Money/CNBC, and in the print and online editions of Forbes magazine. In the MSN Money/CNBC piece[2] (Attachment A), author Jon D. Markman, a weekly columnist for CNBC, pitched his suggestions for investing in what some believe to be a coming global water shortage. In regard to domestic utilities, Markman had this to say:

> "Virtually all of the U.S. water utility stocks are regulated by states and counties, which makes them pretty dull. Governmental entities typically give utilities a monopoly in a geographic region, then set their profit margin a smidge above

[1] U.S. Centennial of Flight Commission website: http://www.centennialofflight.gov/essay/Commercial_Aviation/Bankruptcy/Tran9.htm

[2] Markman, Jon D, "Invest in the Coming Global Water Shortage," MSN.com, January 12, 2005, http://moneycentral.msn.com/content/P102152.asp.

> costs. Just about the only distinguishing factor among them are the growth rates of their regions and their ability to efficiently manage their underground pipe and pumping infrastructure."

Even though investors are aware of these facts, it appears that it has not deterred them from investing in water utility stocks according to John Dickerson, an analyst with Summit Global Management of San Diego who offered these observations in the Markman article:

> "Although not widely appreciated, water has been recognized by conservative investors as an investment opportunity -- and it has rewarded them. Over the past 10 years, the Media General water utilities index is up 133%, double the Return of the Dow Jones Utilities Index. Over the past five Years, water utilities are up 32% -- clobbering the flat returns of both the Dow Jones Utilities and the Dow Industrials. One of water's key long-term value drivers as an investment, according to Dickerson: Demand is not affected by inflation, recession, interest rates or changing tastes."

Both Mr. Markman's and Mr. Dickerson's views are shared by Jeffrey R. Kosnett, the senior editor of Kiplinger's Personal Finance, who had this to say in his February 21, 2006 Kiplinger.com column[3] (Attachment C):

> "If only there were more water stocks. The few publicly traded water companies are pumping marvelous total returns: 25% a year over the past ten years at industry giant Aqua America (symbol WTR) and close to that at others, such as California Water Services (CWT), American States Water (AWR) and SJW Corp. (SJW). Water stocks are also remarkably consitent, with double-digit annualized total returns common across one, three, five and ten years."

[3] Kosnett, Jeffrey R, "California Water: Refreshing," Kiplinger.com, February 21, 2006, http://www.kiplinger.com/personalfinance/columns/picks/archive/2006/pick0221.htm.

Mr. Kosnett went on to state:

> "Water companies' returns are regulated, so the companies are clssified as public utilities. But for investors, they're more like dividend-paying growth stocks -- and not just because of their past performance. Water usage expands with population and housing growth, and water companies are also able to grow by making acquisitions. California Water started expanding to other states in 1999 when it bought into Washington and says it is always scouting around for more opportunities."

What is interesting here is that water stocks are performing well despite the fact that they are typically awarded rates of return that only provide them with a thin operating margin over their costs.

Q. Other than the reasons that you cited in your direct testimony, are there any other reasons why you believe that a cost of equity in the area of 10.00 percent, as opposed to the higher return advocated by Dr. Kolbe, is appropriate for Arizona-American at this time?

A. As I noted in my direct testimony, RWE AG, the parent company of Arizona-American, announced its intentions to sell off its water business segments in the UK and North America. In the November 8, 2005 online edition of <u>Forbes</u> magazine John Dickerson, the same analyst interviewed in the Markman article just cited, stated that he believed that RWE AG will make a public offering of its water holdings. This means that Thames Water and American Water, which was one of the largest and most successful of all of the U.S. water utilities prior to RWE AG's acquisition of it, will probably be purchased on the open market through an initial public offering ("IPO"). From that point the two companies will be traded on a stock market as the other water utilities in my sample are. Mr. Dickerson believes that this is good news for investors, because it will bring down the inflated values of smaller U.S. water utilities. This would mean that water utilities could still offer attractive yields to investors without having to pay out the same percentage of their earnings in dividends that they do now.

Q. Has any of the rebuttal testimony presented by either Dr. Kolbe or the other witnesses for Arizona-American convinced you to make adjustments to your recommended cost of common equity?

A. No.

Q. Does your silence on any of the issues or positions addressed in the rebuttal testimony of the Company's witnesses constitute acceptance?

A. No, it does not.

Q. Does this conclude your surrebuttal testimony on Arizona-American?

A. Yes, it does.

ATTACHMENT A

Jon Markman

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Go back

Posted 1/12/2005

SuperModels

Invest in the coming global water shortage

Fresh water's getting scarce, and it has no substitutes. For investors in companies that can supply our increasingly thirsty planet, that spells opportunity.

By Jon D. Markman

Ten years ago next Monday, a massive earthquake rolled under the Japanese city of Kobe at dawn, toppling 140,000 buildings, causing 300 major fires, killing more than 5,000 people and leaving 300,000 homeless.

To help cover the story for the L.A. Times, I left my wife to care for our 10-day-old daughter and 2-year-old son and flew into the city with a small team of Los Angeles-based trauma doctors and nurses. We found a surreal, smoking ruin of a city with roads twisted like coils of rope, high-rises tilted at Dr. Seuss angles and thousands of middle-class families jammed into dingy, ice-cold rooms in the few public buildings left standing.

Just as in the tsunami zone of South Asia this month, the immediate health danger, besides a possible outbreak of disease, was a lack of fresh water. More than 75% of the city's water supply was destroyed when underground pipes fractured. As much as they desired pallets of drugs, food, blankets and tents sent from throughout Japan and abroad, the Kobe survivors coveted -- and needed -- clean, bottled water for cooking, drinking and bathing.

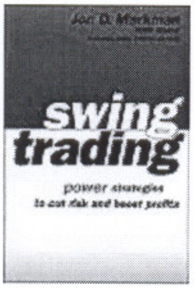
Both incidents are a stark reminder that water is our most precious resource. Because it is seemingly ubiquitous in the United States, it is taken for granted. Massive snowstorms in California this month have loaded up the snowpack that provides water there, and rains in the Southeast are filling reservoirs in that part of the country.

The rest of the world, however, is not so fortunate.

Not making any more water

There is no more fresh water on Earth today than there was a million years ago. Yet today, 6 billion people share it. Since 1950, the world population has doubled, but water use has tripled, notes John Dickerson, an analyst and fund manager based in San Diego. Unlike petroleum, he adds, no technological innovation can ever replace water.

China, which is undergoing a vast rural-to-urban population migration, is emblematic of the places where water has become scarce. It has about as much



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water as Canada but 100 times more people. Per-capita water reserves are only about a fourth the global average, according to experts. Of its 669 cities, 440 regularly suffer moderate to critical water shortages.

Although not widely appreciated, water has been recognized by conservative investors as an investment opportunity -- and it has rewarded them. Over the past 10 years, the Media General water utilities index is up 133%, double the return of the **Dow Jones Utilities Index** ($UTIL). Over the past five years, water utilities are up 32% -- clobbering the flat returns of both the Dow Jones Utilities and the **Dow Industrials** ($INDU). One of water's key long-term value drivers as an investment, according to Dickerson: Demand is not affected by inflation, recession, interest rates or changing tastes.

Virtually all of the U.S. water utility stocks are regulated by states and counties, which makes them pretty dull. Governmental entities typically give utilities a monopoly in a geographic region, then set their profit margin a smidge above costs. Just about the only distinguishing factor among them are the growth rates of their regions and their ability to efficiently manage their underground pipe and pumping infrastructure. Among the best are **Aqua America** (WTR, news, msgs) of Philadelphia, **Southwest Water** (SWWC, news, msgs) of Los Angeles; **California Water Service Group** (CWT, news, msgs), based in San Jose, Calif.; and **American States Water** (AWR, news, msgs) of San Dimas, Calif.

In a moment, I'll offer a couple of potentially more impactful ways to invest in water, but first let's look a little more broadly at world demand.

Aquifers in India are being sucked dry

The tsunami has focused attention on water demand in South Asia -- and it's a good thing, as it was already reaching critical status in rural areas. Several decades ago, farmers in the Indian state of Gujarat used oxen to haul water in buckets from a few feet below the surface. Now they pump it from 1,000 feet below the surface. That may sound good, but they have been drawing water from the earth to feed a mushrooming population at such a terrific rate that ancient aquifers have been sucked dry -- turning once-fertile fields slowly into sand.

According to New Scientist magazine, farmers using crude oilfield technology in India have drilled 21 million "tube wells" into the strata beneath the fields, and every year millions more wells throughout the region -- all the way to Vietnam -- are being dug to service water-needy crops like rice and sugar cane. The magazine quoted research from the annual Stockholm Water Symposium that the pumps that transformed Indian farming are drawing 200 cubic kilometers of water to the surface each year, while only a fraction is replaced by monsoon rains. At this rate, the research suggested, groundwater supplies in some areas will be exhausted in five to 10 years, and millions of Indians will see their farmland turned to desert.

In China, the magazine reported, 30 cubic kilometers more water is being pumped to the surface each year than is replaced by rain -- one of the reasons that the country has become dependent on grain imports from the West. This is not just an issue for agriculture. Earlier this year, the Indian state of Kerala ordered the **PepsiCo** (PEP, news, msgs) and **Coca-Cola** (KO, news, msgs) bottling plants closed due to water shortages, costing the companies millions of dollars.

In this country, shareholder activists already are lobbying companies to share water-dependency concerns worldwide with their stakeholders in their financial statements.

Water, water everywhere, but . . .

The central problem is that less than 2% of the world's ample store of water is fresh. And that amount is bombarded by industrial pollution, disease and cyclical shifts in rain patterns. Its increasing scarcity has impelled private companies and countries to attempt to lock up rights to key sources. In an article last month, the Christian Science Monitor suggested that the next decade may see a cartel of water-exporting countries rivaling the Organization of Petroleum Exporting Countries for dominance in the world economy.

"Water is blue gold; it's terribly precious," Maude Barlow, chair of the Council of Canadians, told the Monitor. "Not too far in the future, we're going to see a move to surround and commodify the world's fresh water. Just as they've divvied up the world's oil, in the coming century, there's going to be a grab."

Besides the domestic water utilities listed above -- and similarly plodding foreign utilities such as **United Utilities** (UU, news, msgs) of the United Kingdom, which sports a 6.9% dividend yield, and **Suez** (SZE, news, msgs) of France -- investors interested in the sector can consider a number of variant plays. None are extremely exciting, but my guess is that, over the next few years, some more interesting purification technologies will emerge, along with, perhaps, a vibrant attempt at worldwide industry consolidation.

One current idea is Tennessee-based copper pipe and valve maker **Mueller Industries** (MLI, news, msgs), a $1 billion business with a trailing price/earnings multiple of 15 that is still not expensive despite a 47% run-up in the past year. Its leading outside investor is **Berkshire Hathaway** (BRK.A, news, msgs), the investment vehicle of legendary investor Warren Buffett.

Another is flow-control products maker **Watts Water Technologies** (WTS, news, msgs), which is a little richer at a $975 million market cap and a trailing P/E multiple of 19, but is still owned by several leading value managers, including Mario Gabelli.

And possibly the most interesting is **Consolidated Water** (CWCO, news, msgs), a $160 million company based in the Cayman Islands that specializes in developing and operating ocean-water desalinization plants and water-distribution systems in areas where natural supplies of drinking water are scarce, such as the Caribbean and South America. It currently supplies water to Belize, Barbados, the British Virgin Islands and the Bahamas, and it has expansion plans. It is the most expensive, but it may also have the greatest growth prospects. Of all of these, it is up the most over the past five years, a relatively steady 355%.

Of course, there is one other benefit to water investing: When these companies say they're going to do a dilutive deal, it's not something to worry about.

Fine Print

Dickerson runs a hedge fund in San Diego strictly focused on water investing, the Summit Water Equity Fund. . . To learn more about Southwest Water, click here. . . . To learn more about California Water Service Group, which runs systems in New Mexico, Hawaii and Washington State, as well as California, click here. . . . To learn more about American States Water, click here. . . To learn more about Mueller, click here, and, for Consolidated Water, click here. . . . Seems like talk is cheap. Since mid-December, the value of the company radio personality Howard Stern is leaving, **Viacom** (VIA.B, news, msgs), has risen 9% while the value of the company he's headed to, **Sirius Satellite Radio** (SIRI, news, msgs), is down 13.5%. . . . For background on the Kobe earthquake, approaching its 10th anniversary, click here and here.

Jon D. Markman is publisher of StockTactics Advisor, an independent weekly investment newsletter, as well as senior strategist and portfolio manager at Pinnacle Investment Advisors. While he cannot provide personalized investment advice or recommendations, he welcomes column critiques and comments at jon.markman@gmail.com; put COMMENT in the subject line. At the time of publication he held positions in the following stocks mentioned in this column: Coca-Cola.

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ATTACHMENT B

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Faces In The News

Money Manager Hails RWE Water Divestiture

Tatiana Serafin, 11.08.05, 2:24 PM ET

In "Liquid Stocks", Summit Global Management's **John Dickerson** discussed opportunities to invest in water companies that were helping build water systems in China and other developing nations. His pick, **RWE**, had investments in the U.K.'s Thames Water and American Water Works of the U.S. and provided investors with dividend yields above the market average and price/earnings ration well below. On November 4, however, RWE announced it would divest its water assets and focus on electricity and gas markets in Europe.

"We are very happy that RWE is planning to get out of the water business," says Dickerson, "and we think in the longer run it will be a healthy development for investors in the U.S. water industry. The disposition of water utility assets in the U.S. is absolutely not an indication that this is a bad business that should be avoided by investors."

Dickerson says that American Water Works was the largest and most successful of all the U.S. water utilities before the RWE purchase (today he says that accolade is with **Aqua-America** (nyse: WTR - news - people)(See "Splash") and predicts that RWE will chose to publicly offer its utility assets because it can get better premiums in public markets. Dickerson does not believe either private equity investors or any other water utility companies would be interested in American Water Works because of the potential high price. He says only **General Electric** (nyse: GE - news - people) would be large enough to swallow American Water Works whole, but companies like GE, **ITT Industries** (nyse: ITT - news - people) and **3M** (nyse: MMM - news - people) have not shown previous interest in water utility assets, preferring to stick to water industrial assets--e.g. filtration, desalination and instrumentation markets.

That's good news for investors. Dickerson says an initial public offering for American Water Works would help bring down inflated multiples of smaller U.S. utilities which is the reason Dickerson moved most of his funds outside the U.S. Better valuations would mean more investment options.

For the moment, Dickerson also recommends sticking with RWE because there is not enough information about pending transactions. He says holding RWE might give existing investors preferential rights with respect to new water shares--a two-for-one bonus.

More Faces In The News

ATTACHMENT C

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February 21, 2006
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STOCK WATCH

California Water: Refreshing
by

Water utility stocks are good growth investments, and they have decent dividends.

If only there were more water stocks. The few publicly traded water companies are pumping marvelous total returns: 25% a year over the past ten years at industry giant **Aqua America** (symbol WTR) and close to that at others, such as **California Water Services** (CWT), **American States Water** (AWR) and **SJW Corp.** (SJW). Water stocks are also remarkably consistent, with double-digit annualized total returns common across one, three, five and ten years.

One of the best performers so far in 2006 is California Water, which is headquartered in San Jose and also has operations in Hawaii, New Mexico and Washington. At $42, it's up 9% from $38 at the start of 2006. Cal Water just announced a strong finish to 2005, with fourth-quarter earnings of 32 cents a share, up from 20 cents a year earlier. Cal Water's full-year 2005 profits were basically flat because of the rainy weather early in 2005 that restrained water consumption. But business is improving again. There's also a $1.15-a-share dividend that works out to a yield of 2.7%. California Water has now raised dividends for 39 straight years.

Assuming normal weather conditions in 2006, analysts James Lykins of Hilliard Lyons and David Schanzer of Janney Montgomery Scott are calling for Cal Water's earnings to jump this year, from $1.48 a share for 2005 to $1.75 and $1.86, respectively. Both reviewed the recent quarter and have a buy rating on the shares. Since water companies are generally trading at 25 to 30 times earnings, the shares would then appear to be headed for around $50.

Water companies' returns are regulated, so the companies are classified as public utilities. But, for investors, they're more like dividend-paying growth stocks -- and not just because of their past performance. Water usage expands with population and housing growth, and water companies are also able to grow by making acquisitions. California Water started expanding to other states in 1999 when it bought into Washington and says it is always scouting around for more opportunities.

--Jeffrey R. Kosnett
